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Economic Conditions
Government Finance

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General Business Conditions

THE end of the steel strike clears the way for a high level of industrial operations during the coming months, provided coal continues available, and opinions as to the business prospect for the Winter and early Spring are now predominantly favorable. It is probable that the steel companies, even operating at capacity, will have to allocate most of their output for a considerable time. Manufacturers of metal products who were forced to curtail for want of steel will also be trying to catch up as rapidly as they can. Coal shortages never became acute, but stockpiles were eaten into and need replenishing. The coal mines have operated at capacity since Mr. Lewis declared his "truce", and if they are allowed to continue to work, which at this writing is a secret known only to Mr. Lewis, they will go all out as long as they can.

Meanwhile, most consumer goods industries have substantial backlogs of orders on hand. The textile mills are in that position. Cotton goods buying now is mostly for the second quarter of 1950. Shoe factories are busy. Paperboard orders rose to phenomenal figures in September and October, providing the mills with good backlogs. Many machinery and equipment manufacturers are operating at a high rate, even where new orders are sluggish. Automobile output will be low during December, due to model changeovers and steel shortage, but it will be stepped up as rapidly as possible after the turn of the year. The construction industry has a volume of business under way which has already guaranteed that 1949 will be the biggest building year in the country's history, while contract awards even this late in the season have continued to break records. Thus 1950 will get off to a strong start.

The Contrast with Last Spring

All this is in marked contrast to the pessimism of last Spring, which foresaw a continuing drop in business and a fourth quarter of at least moderate depression. Many people doubtless are still surprised that the decline stopped when it did, for economic history has seemed to teach that a violent inflationary price rise such as that from 1940 to 1948 must be followed by sharp deflation, deep business recession, and widespread losses. Many thought it inevitable that after the upswing stopped the downturn would be precipitous and costly, as in 1920 and 1921. The drop was sharp for a few months, due to curtailment of business buying in order to reduce inventories. But the feared spiral did not develop, and the rebound has been strong.

The factors which averted a repetition of 1920-21 seem clear. First on any list would be the financial strength and liquidity of people, corporations and financial institutions. Second, the cautious policies followed by so many businessmen during the boom acted as a brake on excessive speculation, borrowing and inventory accumulation, which were the weaknesses of 1920-21. The end of the "catching up" period and the readjustments to peacetime conditions

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did not come all at once, but serially. Finally, the level of income and consumption was supported by varied influences, including government spending, the foreign aid programs, price supports, unemployment compensation, and above all the savings of business and people and their access to credit, which enabled them to go on buying. During the period of curtailment goods were taken off the market faster than they were being produced.

Business is now in a period of mixed inflationary and deflationary influences, and unsure which direction the next major move will take. The orders on the books of the industries, however, show that the downward trend in general has been interrupted and further deflation at least postponed. The problem now is to maintain order and stability during the upturn. Fortunately neither markets nor trade reports suggest that the change in the industrial outlook is leading to any widespread excesses in buying or business planning. The prices of non-ferrous metals, which respond sensitively to business conditions and sentiment, on the whole have been easier. The National Association of Purchasing Agents, which conducts monthly surveys among its members, states that buying of industrial materials and supplies is still held predominantly to a sixty-day coverage, with 82 per cent of those reporting staying within that range.

Inflationary and Deflationary Forces

The chief inflationary forces are the government deficit, including the $2.8 billion of cash to be paid out next month as insurance refunds to veterans, the housing loans on easy terms, increasing consumer borrowings to buy goods on terms which give many observers concern, and the rise in industrial costs which the fourth round wage increase, taking the form mainly of new pension programs, is causing. The chief influences for caution are the downward trend of business expenditures on plant and equipment, and prospective declines in farm income and the export surplus. If business slumps again the higher industrial costs will prove to be deflationary also; for either the resulting higher prices will keep buyers out of the market, or profit margins will be impaired, business enterprise and investment weakened, and the less efficient producers squeezed.

In the broad sense the country is now going through a test period to determine whether it is in fact possible to move down from a highly inflated level to more orderly and stable conditions without an intervening depression. Thus far the answer, provided by the Fall upturn and the good prospects of the next few months, has been favorable. But to the extent that business activity is held up by government deficits it is on an insecure and unstable foundation. People ask how long the deficits can keep up, and whether the penalty of unsound fiscal policy will be another inflation through dilution of the money supply and impairment of its purchasing power, or a deflation because taxes and uncertainty destroy initiative and suppress private savings and investment.

It would be reckless to assume that deflationary influences have fully run their course or that all the industries have completed the adjustment from the postwar inflation to more normal conditions. Few business men make such assumptions. Yet the immediate problem is to avoid piling up new inflationary conditions and creating new weaknesses which would lead to greater instability and produce a more violent reaction. On the part of government the need is to reduce the inflationary pressure and reestablish confidence through economy in expenditures. On the whole economy falls the responsibility of avoiding excesses and reducing costs, to keep manufactured goods prices from moving out of line with the buying power of more and more people.

The Building Boom Continues

The extraordinary rate of residential building activity this Fall almost guarantees that the number of new housing units constructed in 1949 will break all records. In the early months of the year the volume was somewhat below expectations, raising questions whether the peak of the housing boom had been passed, but the rush starting in August has given it new life. During the first ten months the total number of non-farm family dwelling units started (house and apartment) totalled 843,100, or 28,300 more than the same period last year. Indications are that starts in the full year will surpass the all-time high of 937,000 reached in 1925.

Monthly reports of the dollar volume of residential contract awards (work to be started), reported by the F. W. Dodge Corporation, show how the housing market turned upward in the second half of this year, countering the seasonal decline which usually occurs. The figures are for the 37 states east of the Rockies. In the period January through July, awards totalled $1,965 million, which was 10 per cent less than the same period last year. The extra-seasonal activity started in August, and in the three months through October awards totalled $1,420 million. The monthly average was 69 per cent above that

of the first seven months, and 55 per cent above a year ago.

Total residential awards for ten months were 10 per cent ahead of last year, and preliminary reports for November show that the high rate has been maintained.

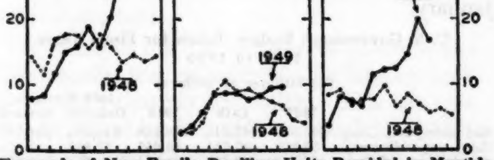
The following table of awards in the 37 states, divided into 15 districts by the Dodge Corporation, shows that in the first seven months of this year all districts except two, New England and Pittsburgh, were behind the same period last year. But in the three months August-October substantial gains over a year ago are shown in all districts except one, New Orleans, which lost ground in August but gained in September and October.

Residential Building Contract Awards in 37 Eastern States

(By Districts, Selected Periods 1949. In Millions of Dollars, and Per Cent Change from Same Period Year Ago)

District	Jan. - July Value	Jan. - July % Chg.	Aug. - Oct. Value	Aug. - Oct. % Chg.	Jan. - Oct. Value	Jan. - Oct. % Chg.
New England	$ 135	+ 7	$ 92	+ 80	$227	+15
Metro. N. Y. & No. N. J.	354	— 9	250	+135	604	+22
Upstate N. Y.	43	— 2	43	+ 80	87	+27
Middle Atlantic	240	—22	207	+ 46	448	0
Southeast	278	— 3	168	+ 71	446	+16
Pittsburgh	57	+ 3	35	+ 27	92	+11
Cleveland	84	—11	73	+ 53	158	+10
Cincinnati	48	—20	34	+ 11	83	—10
South. Michigan	137	— 3	107	+ 84	244	+22
Chicago	212	—19	156	+ 21	368	— 6
St. Louis	92	— 1	56	+ 23	148	+ 7
New Orleans	32	—24	28	0	60	—14
Minneapolis	44	—11	34	+ 29	78	+ 3
Kansas City	73	— 9	45	+ 78	118	+12
Texas	135	— 7	91	+ 68	226	+14
Total	$1,965	—10	$1,420	+ 55	$3,385	+10

As to types of housing contracted for, the Dodge reports reveal that the largest gains have been in apartments and single family houses built for sale or rent, the "speculative" building. The accompanying diagram illustrates the distribution of contracts, by types.



Thousands of New Family Dwelling Units Provided in Monthly Contract Awards, 37 Eastern States.

The Impetus to Home Building

This remarkable upsurge may reflect a return of confidence on the part of prospective builders who had deferred plans earlier this year, during the business recession. Building costs have declined a little, but are not expected to drop rapidly under present conditions. Reasons for postponing needed home building therefore have been less persuasive.

On the financial side the various loan and mortgage insurance plans of the Federal Housing Administration, which were due to expire October 31, have been liberalized and extended to March 1, 1950. Builders may have laid plans to beat the threatened deadline, and to that extent the Fall upsurge may have borrowed something from the future. But another deadline looms in three months. Authorizations for secondary market purchases of guaranteed home mortgages by the Federal National Mortgage Association (a subsidiary of the R.F.C.) have been liberalized and raised from $1.5 billion to $2.5 billion. These purchases support the mortgage money supply.

Another reason, stressed in a joint statement by government housing officials issued November 25, is a steadily increasing concentration of builders' programs on moderate priced housing, after the market for higher priced houses began to lag. In short, the product has been fitted to the market's demands, which is the formula for good business in any industry. The statement stresses, as facilitating the shift, greater productivity and efficiency of labor; greater use of cost-saving design and methods; and virtual elimination of the production delays and overtime, due to shortages in materials and labor which inflated costs in the earlier postwar years.

Further impetus to new housing is coming from the Administration's six-year program to aid construction of 810,000 publicly financed low-rent home and apartment projects, under the Housing Act of 1949. Work on this program began last month when President Truman authorized more than $20 million in loans to local housing authorities in 27 states, the District of Columbia, and Puerto Rico, for planning 134,500 dwelling units. The money for construction is to be advanced by the Federal Government after localities work out detailed plans and costs. It is estimated that around 70,000 units will be started in 1950. Over and above this, states and municipalities have been developing other public housing programs.

How Great the Need?

In view of the activity in new housing, private and public, and the recent extension of government aids along with those already existing, it may be asked whether we are enthusiastically pushing ourselves into overbuilding. A total of about 3,500,000 urban and rural non-farm dwelling units have been started in the four years 1946-1949, according to the Bureau of Labor Statistics – a high rate of activity by any measure, and one which in many areas has provided

substantial relief for the housing shortage. The question remains as to how much housing actually is needed to furnish an adequate number of housing units for the population, and to meet future needs, aside from nebulous estimates of needs according to socially desirable standards.

Some indication may be found in statistics of the number of households as estimated by the Bureau of the Census. The Bureau defines a household as including all of the persons who occupy a house, an apartment or other group of rooms, or a room that constitutes a dwelling unit. Changes in number of households reflect increases through marriages, which have soared since the war, and through the "undoubling" of family units forced by the housing shortage to live "doubled up".

The number of households on April 15, 1949, was reported to be 42,107,000, an increase of 3.4 per cent from a year previous. This is below the increase of 4.0 per cent in 1948 over 1947, which was the peak annual gain. In the 30 years prior to World War II the average annual increase was about 1.8 per cent. The drop in 1949 to 3.4 per cent suggests that the rate has started to decline toward the prewar average, and it has been estimated that in 1950 it will fall under 3 per cent.

The number of marriages has diminished steadily from the peak caused by the war. Together with the "undoubling" that is accomplished as the supply of houses increases, this will weaken the demand as time goes on. But no estimate as to how soon these influences will dampen new housing construction can be made with certainty. As far as 1950 is concerned, the Department of Commerce, whose estimates a year ago of the construction outlook for 1949 were excellent, now forecasts that private residential construction will drop 7 per cent next year, while an increase in public construction will cut the overall loss to less than 5 per cent. If these estimates are realized, 1950 will again be a near-record home building year. Of course much will depend on the success of builders in improving their productivity and labor efficiency, cutting costs, and offering attractive homes at prices within reach of the mass market.

A remarkable feature in the situation is the subsidence of the expressions of alarm, which were so frequently voiced during 1948, over the rapid increase in urban mortgage debt and in the liabilities of the Federal Government, which insures the mortgages. It is true that with abundant supplies of building materials the upward pressure on building costs, which dramatized the inflationary aspects of federal aids and guarantees, has eased this year. However, the expansion of mortgage debt on easy terms — covering 80, 90 and even 100 per cent of present high costs — has continued. Total home mortgage debt increased by three-quarters in three years ending with 1948, and has risen this year at almost the same rate. The more people become habituated to it, the less attention it seems to attract.

Many experienced people, however, have warned of the dangers. It is sufficient to say that if deflation sets in, the aftermath of defaults and foreclosures will fall heavily upon the people who are borrowing too much money, encouraged by too easy terms to take on commitments beyond their means; and after them upon the Federal Treasury, which means everyone. There is all too much reason to fear that this gigantic program of guarantees, including the secondary market provided by FNMA, may lead to the making of too many bad mortgages.

Prospective Federal Deficit

On November 1, after the adjournment of Congress, the Budget Bureau released revised estimates of government revenues and expenditures for the fiscal year ending June 30, 1950 which now give a prospective deficit of $5.5 billion. The President had already forecast, last January, a deficit then figured at $873 million, unless taxes were increased. The swollen deficit now projected reflects in part another of the familiar upward revisions in expenditures. Against the $40 billion actual expenditure total in fiscal '49, and the January estimate for fiscal '50 of $41.9 billion, the spending figure is now put at $43.5 billion.

Revenues are estimated at $38 billion, about the same as were actually realized in fiscal '49, but $3 billion below the original estimate last January.

U. S. Government Budget Totals for Fiscal Years 1947 to 1950

(In Millions of Dollars)

	1947	1948	1949	1950 Estimate Original	1950 Estimate Revised
Net receipts	$40,043	$42,211	$38,246	$40,985	$38,000
Total expenditures	39,289	33,791	40,057	41,858	43,500
Surplus or deficit	+754	+8,419	—1,811	—873	—5,500

Net receipts shown after deducting tax refunds. Expenditures for international aid distributed on basis of actual disbursements.

The revised estimates this year came out later and are much less detailed than usual, a result of the exceptionally long session of Congress. Nevertheless the new figures do reveal the major changes in the various programs. These changes may be seen from the accompanying summary for the current fiscal year which compares the original budget estimates submitted in

January 1949 with the revised figures issued in November 1949:

U. S. Government Estimated Budget Expenditures for Fiscal Year 1950

(In Billions of Dollars)

Expenditures	Original Estimate Jan. '49	Revised Estimate Nov. '49	Decrease	Increase
Programs showing major changes:				
Dept. of Defense — military programs	$13.2	$12.3	$0.9	$ —
Veterans' pensions	2.1	2.2	—	0.1
Veterans' readjust. benefits	2.2	3.0	—	0.8
Veterans' Life Insurance Fund	0.1	0.5	—	0.4
European Recovery Program	4.5	4.1	0.4	—
Commodity Credit Corp.	0.6	1.4	—	0.8
R.F.C. mortgage purchases	0.2	1.3	—	1.1
Postal deficiency	0.2	0.6	—	0.4
Interest on the public debt	5.5	5.7	—	0.2
Universal training (proposed)	0.6	—	0.6	—
Aid to education (proposed)	0.3	—	0.3	—
Subtotal	29.5	31.1	2.2	3.8
All other programs	12.4	12.4	—	—
Total budget expenditures	$41.9	$43.5	—	$1.6

From the increase that occurred in the overall estimate of expenditures, it will be seen that while economy efforts won some battles they lost the campaign.

Reductions in projected expenditures under the national defense and the European Recovery programs, plus the rejection of the proposed universal military training and additional federal aids to education, brought about savings of $2.2 billion. These were more than offset, however, by a $1.3 billion increase in estimated expenditures under veterans' programs, a jump of $1.1 billion in outlays by the R.F.C. for investment in mortgages, a rise of $800 million in outlays by the Commodity Credit Corporation to support farm incomes, and increases in the postal deficit and in interest charges.

The difficulty of controlling public spending, despite the heavy burden of taxes and the frequent demands that taxes should be lowered, rather than increased, is illustrated in the action of the last Congress on the various programs showing major increases in expenditure as listed in the above table.

For example, the cost of veterans' pensions and other benefits was estimated in the January budget at approximately $5.5 billion. This has now been increased by $1.3 billion, including (1) $800 million for readjustment benefits, mainly education and training allowances, as a result of a larger number of participants and higher costs per veteran than had been anticipated, (2) $100 million for pensions, as a result of legislation liberalizing some benefits and of higher payments per case, and (3) $400 million transfer to the National Life Insurance Fund, resulting from a resurvey of the Government's contributory liability. Despite the fact that increased Treasury appropriations have been found necessary to build up the reserves to meet the liabilities under veterans' life insurance policies, a special dividend of $2.8 billion is to be distributed to policyholders early next year. The President's budget recommendation to cancel $227 million of authorized but unneeded veterans' hospital construction was rejected by Congress.

Aside from expenditures for veterans, the next largest increase in the revised budget was $1.1 billion for net expenditures by the Reconstruction Finance Corporation for purchases of housing mortgages. The purpose of the enlarged authority granted by Congress this year was to provide a secondary market for home and rental housing mortgages, which are made through lending institutions and guaranteed by the Federal Housing Administration and the Veterans Administration, and have been rising sharply since last Spring. These include many mortgages of such doubtful character that lending institutions are unwilling to hold them.

An increase of $400 million in the Post Office Department deficit footed by the Treasury reflects both an increase in the estimated expenses, and the failure by Congress to raise postal rates by $250 million annually as proposed by the President. An increase of $200 million in interest on the public debt results from a change in the bookkeeping methods, by which interest is now computed on a due-and-payable basis, instead of being charged as formerly to expenditures only when actually paid.

Outlays to Hold Up Food Prices

Commodity Credit Corporation net expenditures, principally for farm price supports, are now estimated at $1.4 billion, or $800 million higher than last January, as a result of above-normal crops and declines in some commodity prices. This sharp expansion in price support activities not only is keeping costs of food higher than they should be, but at the same time imposing a heavy financial burden on the Treasury and contributing to the budget deficit.

During fiscal '49, the C.C.C. reported an operating loss of $600 million, of which $248 million was for direct losses already sustained under the various price support programs, $336 million to provide for future losses on inventories owned, and the balance for operating expenses not covered by loan income.

At the peak of its price-support operations during the past season, C.C.C. laid out more than $3.4 billion in loans and direct purchases, as shown by the accompanying table. Through repossessions and sales, these commitments were paid down by June 30, 1949 to $2,352 million.

C.C.C. Price Support Outlays on 1948 Crops

Commodity	Unit	Quantity (Millions)	Value (Millions)
Cotton	bales	5.8	$822.0
Wheat	bus.	367.5	749.5
Corn	bus.	555.6	767.2
Peanuts	lbs.	1,361.8	170.0
Potatoes	100 lbs.	101.9	228.2
Flaxseed	bus.	26.6	159.0
Linseed Oil	lbs.	304.5	82.0
Tobacco	lbs.	221.7	102.2
Beans	100 lbs.	8.4	68.4
Wool	lbs.	80.7	63.1
Barley	bus.	49.5	55.8
Grain sorghums	100 lbs.	22.3	55.8
Dried eggs	lbs.	28.4	36.2
Soybeans	bus.	11.0	24.6
All others			65.7
Total			$3,449.2

The magnitude of these operations may be appreciated by comparison with the size of the crops harvested in 1948. For example, C.C.C. through its loan and purchase programs held off the market 79 per cent of the flaxseed crop, 70 per cent of the peanuts, 40 per cent of the dried edible beans, 38 per cent of the potatoes, 35 per cent of the cotton, 29 per cent of the wheat, and 15 per cent of the corn. By the time of the 1949 harvests, C.C.C. still was holding previous crops to the extent of 3,800,000 bales of cotton, 227,000,000 bushels of wheat, and 555,000,000 bushels of corn, as well as many other crops.

At the present time, C.C.C. is holding over 100,000,000 pounds of butter – a full month's consumption, flaxseed and linseed oil supplies equivalent to a full year's normal requirements, and dried eggs amounting to around 70,000,000 pounds – a ten years' supply! It also owns large quantities of a wide range of other agricultural commodities including cheese, dried milk, peanuts, soybeans, prunes, raisins, potatoes, potato starch, barley, dried edible beans, grain sorghums, oats, dried peas, rice, rye, hay seed, wool, frozen eggs, wool, rosin, and turpentine. It soon is expected to go for the first time into new price support fields, including tung nuts, walnuts, almonds, honey and mohair.

Under the new Farm Law recently passed by Congress, which becomes effective on January 1, loans on the 1950 basic crops – wheat, corn, cotton, tobacco, peanuts and rice – will again be held at the wartime 90 per cent parity level. While discretion has been given to the Secretary of Agriculture to reduce supports for other commodities to 75 per cent of parity and in some cases even lower, most parity prices will actually be higher next year under a new formula which changes the base period and includes an allowance for the rise in farm wages. Reduction in acreage is being called for in cotton, wheat, corn, rice, and potatoes, but it is expected that much of this released acreage will merely be diverted into other crops on which no statutory controls are exercised, thus further piling up surpluses and adding to the price support outlays.

Can Spending Be Controlled?

When Congress again convenes in January, it will be faced with the critical issue of what to do about the deficit, not only in the current fiscal year but also in fiscal 1951, for which the official budget estimates will then be presented.

It is little wonder that the public is becoming skeptical as to whether the rising tide of government spending can be controlled in view of the heavy costs of the "cold war" and the other heavy expenses resulting from World War II, including veterans' benefits, foreign aid, and interest on the public debt. Congressmen are constantly pressed by their constituents with the argument that if we can afford to spend all these billions for relief and reconstruction abroad, why can't we afford to spend for this or that project back home, the costs of which individually may be relatively small but taken together also mount up into the billions.

Moreover, a vast vested interest has been built up by the ever-increasing numbers of people now receiving government payments in one form or another. In its issue of November 4, the U. S. News and World Reports published an analysis of the Federal Government disbursements throughout its manifold activities for salaries, pensions and other benefits, food subsidies, insurance and guarantees, purchases of services and materials, etc., which indicated that regular payments were being made to approximately 19,300,000 persons. In addition, state and local governments are making regular payments to 6,400,000 persons, making a total of 25,700,000 now receiving public checks. All of these recipients tend to feel a much more specific interest in such receipts than in the tax payments they make, and for which they would still be liable even if they personally refused to accept the payments offered to their groups.

These conditions tend to breed a growing defeatism toward the ability to balance the budget, which unless changed would make the long-term outlook hopeless.

Actually, however, with a budget totaling over $40 billion, it is impossible to believe that there is no room for very substantial savings. Senator Harry Byrd, chairman of the Congressional Joint Committee on the Reduction of Nonessential Federal Expenditures, has proposed that federal spending could be cut $10 billion or more annually "without impairment of the Government's integrity or its essential security and general

welfare functions," and that this should be followed by tax reductions of $7 billion. In an article in the current Annals of the American Academy of Political and Social Science entitled "A Tax Policy for a Prosperous America", he called for (1) a cut of $3 billion by eliminating recent increases in "more than 300 budget items," (2) an additional $2 billion slash in "nonessential and deferable domestic civilian expenditures," (3) a reduction of $3 billion in defense spending through "prompt and effective unification" of the armed services, and (4) a $2 billion cut in foreign aid expenditures.

That large amounts can be saved without sacrificing essential objectives has been shown by other expert investigations, including those of the Hoover Commission, Committee for Economic Development, Committee on Public Debt Policy, National Association of Manufacturers, and the Chamber of Commerce of the U. S.

Some Encouraging Signs

What is needed now is determination on the part of those in authority to accomplish savings and a public support for their efforts. There are at least some encouraging signs in this direction. In the case of the $15 billion national defense budget, President Truman made repeated efforts this year to hold down the costs, and opposed particularly the expansion voted by Congress in the size of the Air Force. Louis Johnson, Secretary of Defense, reiterated in an address on November 18 that he hoped to slash $2 billion from the present budget and that this saving would still permit the country to remain "adequately prepared to face any military crisis." Continuing, Mr. Johnson declared:

> We are going to get along on this lesser amount because we know our economic system cannot afford to pay much more. We not only are trying to get along on less, we will get along with a whole lot less. Moreover, we will get a lot more for our money; it will be a matter of less money and more defense.

On the same day, Paul Hoffman was reported in the press as saying that he would seek considerably lower dollar aid for Western Europe next fiscal year; and Senator Connally, the Democratic Chairman of the Senate Foreign Relations Committee, stated that E.C.A. aid should be reduced by one billion dollars from this year's level. This would be in accord with the original idea of the foreign aid program, which called for a declining rate of spending until its complete termination in 1952.

Within the past few months Allan Kline, President of the American Farm Bureau, and Albert Goss, President of the National Grange, have come out in favor of flexible price supports for agriculture, and in opposition to both the rigid 90 per cent of parity supports and the Brannan Plan. These extravagant plans for agriculture are not supported by the principal farm leaders.

Within the past few weeks, Paul Douglas, the junior Democratic Senator from Illinois, announced his opposition to the unbalanced budget and urged a budget balance through reducing expenditures.

All this affords hope that the American people are awakening to an understanding of the problems and dangers we face. It reveals the presence of leaders with courage and conscience. The coming months will be a testing time to see what kind of leadership will prevail, the unscrupulous appeal to blind self-interest or the appeal to reason in the long-term national interest.

The Compensatory Budget — Theory vs. Practice

The federal budget deficit for the current fiscal year, if it reaches the officially estimated proportions of $5½ billion, will be the largest ever experienced in peace-time. While many counsels have been heard that the national government should be prepared to run up big deficits in time of depression, this 1950 deficit comes in a period of prosperity. No one planned it this way. So far as the public record goes, it just happened.

There are, to be sure, those who, without defending the deficit, see in it the assurance of sustained incomes and large markets for the goods that are produced. So far as they rest their case sheerly on the flow of purchasing power from government into the hands of the public, these people are doubtless correct in their reasoning. But government deficits have harmful effects which are not diminished by the fact that these effects elude precise measurement. It should never be forgotten that the modern society rests on the will of the citizen to work to earn money, and it is work that makes production and production that makes prosperity. Persistent government deficits weaken the will to work in two ways: they make money more plentiful and easier to get, and they hold the threat of tax increases which depreciate the value of an extra dollar's earnings. In both these ways they undermine the essential base of prosperity. While plenty of easy money can create illusions of prosperity, these illusions crash when depreciation in the buying power of money is recognized.

Prosperity Unquestioned

Even if we could not trust to our own observations, we have it on the authority of Secretary

of the Treasury Snyder that, despite the mild setback to business last Spring, the country is prosperous. In a speech a month ago he said:

> Both incomes and jobs — in the aggregate — have held up, month after month, at close to the all-time record level of last year. Incomes, so far this year, have averaged even higher than in the same months of the highly prosperous 1948. Total civilian employment in recent months has been practically at the 60 million figure; and unemployment, at its seasonal peak during the summer, amounted to a little over 6 per cent of the total labor force.

In the same speech, Mr. Snyder gave credit to "a spirit of genuine cooperation on the part of the great majority of our taxpaying citizens" for the high level of tax collections and reminded his audience that "ours is one of the few countries in the world today that is able to rely for the major portion of its revenue on taxes that are voluntarily reported and paid by the mass of its citizens." Under these favoring circumstances — and with the flush tax revenues that come out of a high-tax system in a period of prosperity — a deficit does not fit any responsible theory or principle.

In his midyear Economic Report the President warned that "we cannot expect to achieve a budget surplus in a declining national economy." But no one has said that the 1950 deficit is planned to shore up "a declining national economy." The President has put the onus for the deficit on Congress for the 1948 tax cut. Others put the blame on the so-called "cold war". Neither of these explanations carries conviction. Surely, a $9.7 billion increase in expenditures since 1948 has more to do with the deficit than a tax measure that gave up some $4 billion in revenues. And if "cold war" considerations ruled the budget we would have domestic spending programs pruned down instead of swollen by $5.7 billion since 1948.

U. S. Government Budget Receipts and Expenditures
(In Billions of Dollars)

	Fiscal Years		
	1948	1950 est.	Change
International affairs and finance	$ 4.8	$ 6.3	+$ 1.5
National defense	10.9	13.4	+ 2.5
All other expenditures	18.1	23.8	+ 5.7
Total expenditures	$33.8	$43.5	+$ 9.7
Total receipts	42.2	38.0	— 4.2
Budget surplus (+) or deficit (—)	+ 8.4	— 5.5	— 13.9

It is easy to understand the President's expressed view that expenditures "cannot" be reduced. The pressures to spend focussed upon his office, and upon the Congress, approach the irresistible. It is hard to say "no" and make it stick when there is no rule, principle, or fact to enforce that answer. As James F. Byrnes, former Secretary of State, declared two weeks ago, people have been "misled into regarding the Treasury as a Christmas tree with the President and the members of Congress playing the role of Santa Claus." Mr. Byrnes, an old hand on the Washington scene, should know whereof he speaks.

Bankruptcy of a Doctrine

The unbalanced budget for the 1950 fiscal year represents, as much as it represents anything, the bankruptcy of the "compensatory budget" doctrine. This doctrine was born out of proposals for public works to create jobs during depression. From 1933 onward it was embellished and taught as the means to everlasting prosperity by the brilliant English economist, John Maynard Keynes, and his disciples. Its final stage of evolution was into the political formula, attributed to the late Harry Hopkins, of spending, taxing, and electing.

Mr. Keynes, seeking in the great depression a simple and salable "device" to put more money into circulation, to raise prices and incomes and to create more jobs, campaigned for government "loan-expenditures" as the way to do it. Government deficits in depression are nothing novel. We had them in 1931, 1932 and 1933. They did not have to be planned because they arose naturally out of a falling off in revenues, plus some emergency outlays. But the deficits, Mr. Keynes thought, were not big enough. He even suggested tax reductions as a means of stimulating private expenditures, and at the presumed expense of even larger deficits. This latter suggestion fell on fallow ground but enlarged government spending out of borrowed money had an immediate appeal, not only among government officials whose departments could be expanded, but also among prospective recipients — such as people out of work, farmers, the construction trades, merchants and manufacturers — who were pleased at the prospect of bigger incomes, higher prices, and government orders.

Under the theory, the deficits were not to last very long. It was assumed that as private incomes and enterprises expanded, tax revenues would increase, emergency government outlays would be cut out, and the budget would be balanced automatically on a prosperity level.

There was some question as to where the money would come from for the Government to finance its deficits. Here the banks of issue, with their credit-issuing powers, were relied upon to keep interest rates low and prices of government securities high. Currencies were devalued and gold convertibility for the private citizen was

abolished. In this country the statutory public debt limit, raised time and again, became quite meaningless. By such means, and by making a virtue of deficits, the brakes were taken off government spending. The Treasury was made over into a "Christmas tree".

Failure in the Thirties

The scheme – dubbed "pump-priming" – did not work out according to plan during the '30s, and, if the war had not shut off the debate, controversy might still be raging as to why it did not work. The amount of money in circulation was increased, and also money incomes, prices and the cost of living. Prosperity seemed within range, if not actually achieved, in 1937 as unemployment declined to 7,700,000, the low point of the decade according to U. S. Bureau of Labor Statistics estimates. But business slid off in 1938, and unemployment rose beyond 10,000,000 again.

Quite contrary to the theory, government expenditures increased instead of decreasing with recovering business. In fiscal '36 and again in '37, government expenditures exceeded $8 billion, more than double the fiscal '33 rate. The '36 and '37 expenditure figures were swollen by "non-recurring" bonus payments to veterans, but more important were climbing public works expenditures, unemployment relief payments of diverse kinds, and enlarged outlays under almost every budget heading. The following table gives a condensed comparison of expenditures in fiscal '37 and in fiscal '33.

U. S. Government Receipts and Expenditures — Fiscal Years 1933 and 1937
(In Millions of Dollars)

	1933	1937	Change
Net receipts	$2,080	$5,029	$+2,949
Expenditures			
Legislative, judicial and civil	638	815	+ 177
National defense	680	929	+ 249
Veterans	849	1,128	+ 279
Public works	459	1,079	+ 620
Unemployment relief	345	2,432	+2,087
"Agricultural adjustment"	—	527	+ 527
Interest on the public debt	689	866	+ 177
Other expenditures	83	—202*	— 284
Transfer to trust accounts	121	603	+ 482
Total expenditures**	$3,864	$8,177	$+4,313
Deficit	$1,784	$3,148	$+1,386

*Excess of credits; deduct. Reflects loan repayments.
**Excluding statutory debt retirement.

Also, contrary to theory, the budget never came into balance and this despite one tax increase after another. The deficits, mostly around $3 billion, ranged from $1.4 billion in fiscal '38 up to $4.5 billion in '36. The federal debt climbed from $22½ billion on June 30, 1933, to $40½ billion on June 30, 1939.

New theories were spun to explain the chronic state of depression or semi-depression. The American economy was "mature" and "stagnant". The fact was disregarded that departures of the Government from time-tested rules of financial management, along with many disturbing economic experiments and reforms, were a source of uneasiness. The dismal succession of tax increases alone was enough to make any economy lose vigor and become prematurely old.

The prescribed medicine always was "more government spending." In 1940, writing in the New Republic, Mr. Keynes had drawn the conclusion: "It appears to be politically impossible for a capitalistic democracy to organize expenditure on the scale necessary to make the great experiment which would prove my case . . . except in war conditions."

Ballooning of Expenditures

The postwar record on public works programs, like that during the '30s, denies the theory that such programs are easily flexible and controllable, and can be kept on the shelf waiting for a depression. Under the fear that government expenditures would be cut down too much at the end of the war, a large public works program was set in motion. Thus civil public works expenditures (including loans and grants) have risen successively from $677 million in fiscal '46 to $1,457 million in '47. The 1948 rise, to $1,620 million, was less rapid as cuts were made to accommodate tax reductions. Neither the final figure for fiscal '49 nor the revised estimate for fiscal '50 is available but the prospect in January was for a continued rise to beyond $3 billion in fiscal '50. The President's budget for the fiscal 1948 year explained:

> The present situation of a rapidly expanding public works program results almost entirely from action taken in 1945 and 1946 when legislation was enacted providing large public works authorizations for loans, grants, and direct construction, and making appropriations for starting many major projects.

The President's budget for fiscal 1950, issued last January, at a time when he was advocating vigorous anti-inflation controls, stated:

> New major projects are recommended only where the public need for them is so urgent that it is not in the national interest to postpone them.

The national interest can cover a multitude of sins. In the Congressional debate last May on a $751 million Army "civil functions" bill, Senator Douglas of Illinois used more explicit language:

> I think we all know that this is the bill upon which we can save tremendous amounts of money if we really want to do so. In the old days, when I first began to read the congressional debates, this historic bill was called the rivers and harbors bill. It was also commonly, if irreverently, referred to by the people as 'the pork barrel.' It was commonly believed that sufficient fat chunks of appropriations were passed around among the various districts and States to insure its passage.

> This bill is now being marketed within a comparatively new package. It is no longer labeled the rivers and harbors bill, but about a quarter of a century ago its name was changed, and it has now become the civil functions of the Department of the Army bill. This has a very impressive and dignified sound, but when the new wrapping is peeled off I have a very real feeling that, however succulent the slices, it is still the same old bologna.

Senator Douglas failed in his effort to cut $300 million from the appropriation bill. President Truman, in the Fall of 1946, had a similar experience. He ordered cutbacks "to reduce inflationary pressures" but had to give up the effort under the storm of protests from interests and localities affected.

A Will-O'-The-Wisp

Neither does the theory work that governments can balance their budgets by spending more. The vast government expenditures during the war, any more than the accelerating expenditures during the '30s, did not strike a balance in the national accounts. Neither, if we take the new budget estimates, is the acceleration of government expenditures from $33.8 billion in 1948 to $43.5 billion in 1950 going to balance the budget in 1950. The balanced budgets that are supposed to come about after enlarged government expenditures "prime the pump" have never been more than a will-o'-the-wisp, a bait for the credulous.

Curiously, and quite contrary to all the theory, the only balanced budgets that we have enjoyed in nineteen years – those of 1947 and 1948 – came as a sequel to *reduced* government expenditures and taxes.

Re-controlling Government Expenditures

To cut government expenditures there has to be more than a theory. There has to be a *reason*. One of these is to have a balanced budget. A second is to have a surplus for debt retirement. A third is to make possible lower taxes. It was the combination of these forces which, in 1948, held expenditures to $33.8 billion, and produced an unprecedented $8.4 billion surplus, a part of which was earmarked for tax reduction, and another part for debt retirement.

Now that expenditures are threatening to pass the $43 billion mark it would seem that "compensatory budget" advocates would raise strident voices in protest. Instead, they tend to place the burden of the blame for the current deficit on the 1948 tax reduction. A conference of university economists, held at Princeton six weeks ago, had this comment in a report on federal revenue and expenditure policies:

> Past decisions on taxes and commitments on expenditures have resulted in a current deficit in the cash budget. We regard those decisions as unfortunate, in particular the decision in 1948 to reduce taxes; it would have been the course of sound policy to have revenues exceeding or, at the least, equaling expenditures at the present level of business activity.

This group of economists, which included some distinguished names, presents an elaborated and modernized version of the Keynesian-inspired "compensatory budget" now under the name of "countercyclical fiscal action." Public works, despite their perverse behavior during the '30s and since the war, are again relied upon as an economic stabilizer. Prompt legislation is recommended to set up a "shelf of public works", composed of projects "that are economically desirable, and that can be started promptly when the need for additional government spending arises, and completed or stopped promptly when this is no longer needed."

More emphasis is given to "tax flexibility" than in the original theory – lowering taxes in depression and raising them in prosperity. No substantial experience is available for testing this part of the theory. Great courage is required of Congress to raise tax rates in prosperity when revenues are already booming or to lower the rates when revenues are falling. Frequent juggling with tax rates, moreover, makes difficult orderly planning for the individual and business as well as for tax administrators. There is a question too whether tax cuts in depression could be fully effective stimulants if government expenditures were rising at the same time and holding the threat of taxes higher than ever when, as, and if business recovered. Tax cuts, with restraint in government spending and within a balanced budget, as we can see today in Canada, not to mention in our own longer experience, are a workable formula for prosperity.

Gone from this newest statement of the theory is the easy assumption that government expenditures will contract in periods of prosperity. Reductions in expenditures "must be part of a constant and continuing effort." Those efforts "cannot be turned on and off at will."

But how do we get really effective economy efforts when there is no rule of the balanced budget to set a limit? Here the report freely admits the perils:

> Were expenditures divorced entirely from the need for taxation, political opposition to extension of the government's expenditure programs would largely disappear. The scale on which the public sector absorbs resources would grow beyond what was really desired by the people as a whole; sooner or later the country would find itself in a state of chronic inflation.

What then must be done?

> Accordingly, other general principles, other habits of thought and of action must be set forward to insure the standards of judgment and the self-discipline of government's activities and to do better what the principle of annual budget policy attempted—though imperfectly—to accomplish.

This is sufficiently vague to afford no rule at all. And the report, a little later, frankly leaves as "one of the major questions for the future . . . how such a policy (of contracyclical fiscal action) can be administered with the restraint and efficiency that is supposed to be achieved through the balanced budget rule." If, lacking a rule of restraint, government expenditures can only go up, how can taxes ever come down? There is hardly anything that can create a bleaker outlook for a citizen than a prospect that, over the years, the Government is going to appropriate more and more of his income and leave less and less for his own use and enjoyment. Keynesian economics, no less than the Malthusian variety, emerges as a dismal science.

The Rule of the Balanced Budget

The economists' report above-mentioned critisizes the principle of annual budget balancing as "difficult in practice and *unsound in principle*" (italics ours). There is no question but that budget balancing is "difficult in practice." It always has been. Every Congress, every President, has had a struggle to fend off raids on the national treasury. The difficulties are immeasurably increased when the Congress and President are told that it is *unsound in principle* to try to keep a balanced budget.

In any well ordered society government expenditures must be subject to limit. The principle that the budget should be balanced sets the limit at the equivalent of revenues. One passage in the economists' report states the merit of budget balancing very well:

> Annual budget balancing is, thus, both difficult in practice and unsound in principle. But one great merit it does have: it provides a yardstick by which legislators and the people can scrutinize each activity of government, testing it both for efficiency of operation and for its worth-whileness in terms of cost. Every government program undertaken has to be paid for in a clear and unequivocal sense. The legislature and the executive are required to justify additional taxes equal to the cost of any new program. This is a principle every citizen can understand. If dropping the principle of annual budget balancing were to mean dropping all restraints to unwise and inefficient expenditure, grave damage would be done to our economic and political system.

The error here—and it is fundamental—is the assumption that there can be "restraint" on "unwise and inefficient expenditures" if there is no "principle that every citizen can understand" to enforce that restraint. The $5 billion deficit stands witness to what can happen to expenditures when the principle of a balanced budget is thrown on the discard heap. As President Cleveland wrote in his last Annual Message to Congress in 1896, "The way to perplexing extravagance is easy but a return to frugality is difficult."

A second line of restraint on government expenditures is the defense of the national credit. That credit has held strong because the Government, as a rule, has treated its debts responsibly. Any splurge of excessive borrowing naturally registers itself in declining prices of government securities and rising interest cost of government borrowing. A warning flag is run up and, generally in the past, it has been obeyed.

But in the present day the Federal Reserve Banks are used to keep interest rates down and government security prices up. So long as this arrangement lasts, the Government has little concern of running out of money and having to limit expenditures to available revenues or any other precise figure. Pressure to pay down the public debt is weakened, and temptation to borrow and spend approaches the irresistible.

Positive Brakes Needed

All experience shows that governments will not restrain their spendings without some compulsions. We need brakes, effective and positive-acting.

One brake is the fiscal golden rule of a balanced budget. It needs to be put back in working order, and to be accepted on all sides as a rule to be obeyed. Unbalanced budgets do not have to be planned for. Balanced budgets do.

A second brake we need is a provision for renewed debt retirement. Experience suggests that a scheduled sinking fund formula may be necessary to insure that such a provision is made. The amount does not have to be large but it has to be there.

A third essential brake is the promise of tax reduction to the citizen. There is no lever more powerful for accomplishing economy in government.

A fourth brake is a more natural market for government securities under which the laws of supply and demand will work and unsound fiscal policy will be reflected in declining price quotations.

A fifth brake is a tightening of the tie of the dollar to its gold base, as suggested in the November issue of this *Letter*.

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